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MEMORANDUM RE RELIEF FROM STAY AND STAY PENDING APPEAL

On April 26, 2002, this court held a hearing regarding an order to show cause why relief from stay should not be granted to permit a secured creditor to foreclose upon Debtor's real property. John Poppin and Matthew J. Shier appeared for Debtor. Terrence V. Ponsford and Craig Stuppi appeared for Secured Creditors ITW Mortgage Investments II, Inc. and GE Capital Realty Group, Inc. (ITW). In response to ITW's motion for relief from stay, the court had previously held a hearing to determine the value of the property. The court later held a hearing at which the court denied confirmation of Debtor's First Amended Plan of Reorganization. I now determine that ITW should be granted relief from stay, and that neither the denial of confirmation nor the relief from stay should be stayed pending appeal. **FACTS** Debtor's only significant asset is a large office building in San Francisco known as Hawthorn Plaza (the Property). The Property is encumbered by a loan from ITW secured by a deed of trust. Debtor was initially unable to rent all of the space in the building, and was consequently unable to make debt service payments. The loan was modified six times to add unpaid interest to principal. Debtor finally achieved complete occupancy and thereafter timely paid the debt service. Debtor filed the present bankruptcy because the ITW loan matured and Debtor was unable to find replacement financing. The original maturity date on the loan was September 1, 1992, but was extended to December 31, 2000 through the loan modifications noted above. Two factors made it difficult for Debtor to obtain a new loan. First, the addition of unpaid interest to the loan balance increased the loan-to-value ratio. This meant financing on conventional terms could be obtained only if the building maintained a high appraised value and produced a large net operating income. Second, at about the time Debtor filed this chapter 11 case, the market for San Francisco office buildings collapsed, especially for properties in the South of Market area where Debtor's building is located. This meant that the Property did not have the high enough appraised value to qualify for conventional financing. Debtor filed a chapter 11 petition on July 24, 2001 to stop ITW's scheduled foreclosure. ITW filed a motion for relief from the automatic stay. The court held an evidentiary hearing at which it determined the value of the building to be \$97 million and the balance on the ITW loan to be approximately \$99.5 million. Having determined that Debtor has no equity in the Property, the court conditioned the continuation of the automatic stay on Debtor confirming a plan promptly. Debtor filed a plan that called for ITW to retain its lien, for

ITW to be paid interest at 8.35 percent, and for the maturity date of the loan to be extended for five years. ITW objected to confirmation, contending, inter alia, that the interest rate was not sufficient. At the confirmation hearing, both parties introduced expert testimony regarding interest rates. ITW's expert, Richard Ferrell, testified that the appropriate blended rate of interest should be 11.27 percent, calculated as follows. **Tranche L-T-V Ratio Interest Rate**

First	Up to 70%	6.98%
Second	70-85%	17.5%
Third	85-100%	25%

Debtor's counsel did not cross examine Mr. Ferrell. The court found that the three-tranche approach was appropriate, but that the appropriated blended rate of interest was "at least" 10 percent, calculated as follows. **Tranche L-T-V Ratio Interest Rate**

First	Up to 70%	7%
Second	70-85%	15%
Third	85-100%	20%

The court denied confirmation of the plan. Using the Debtor's own projections regarding net operating income before debt service, the court found that the Property did not have sufficient cash flow to pay ITW interest at 10 percent. The court then issued the present order to show cause why relief from stay should not be granted.

RELIEF FROM STAY This court previously determined that Debtor has no equity in the Property. Under section 362(d)(2) of the Bankruptcy Code, where a debtor has no equity in property, relief from stay should be granted unless the property is "necessary to an effective reorganization." Under section 362(g), the debtor bears the burden of showing that necessity. Moreover, the debtor must show not only that the property is necessary if there is to be a reorganization, but also that the debtor can confirm a plan within a reasonable period of time. *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)* 2 F.3d 899, 902 (9th Cir. 1993), cert. granted, 510 U.S. 1039 (1994), motion to vacate denied, case dismissed, 513 U.S. 18 (1994). In the present case, there is no doubt that Debtor needs to keep the Property to reorganize, the question is whether Debtor can actually confirm a plan. I find that Debtor is not likely to confirm a plan within a reasonable period of time. Confirmation of Debtor's first plan was denied because Debtor did not have sufficient cash flow to pay interest on ITW's claim at the rate necessary to confirm the plan over ITW's objection. Debtor now proffers an alternate plan under which it will repay part of the ITW loan

immediately and repay the remainder over five years. Under one option, Debtor will obtain a new first loan in the amount of \$75 million at 5.4 percent interest. Debtor states that it would then be able to pay the remaining two tranches of the ITW loan at the rates previously determined by the court. Under a second option, Debtor would obtain a new junior loan of \$14.5 million for 9 percent interest plus an unspecified equity participation. This would enable Debtor to pay the first two tranches of the ITW loan at the rate previously determined by the court and still have enough cash flow to pay the new junior loan. I find that it is unlikely that Debtor can obtain the new first loan necessary to implement the first option under Debtor's alternative plan. Debtor has been searching without success for new financing since well before the ITW loan matured on December 31, 2000. Debtor does not represent that Debtor has a commitment for the new first loan. Moreover, the court found that the appropriate rate of interest on a conforming first loan is 7 percent, not the 5.4 percent Debtor hopes to get. Thus, there is no reason to believe it is likely Debtor will be able to secure such financing within a reasonable period of time. I find that it is also unlikely that Debtor can obtain the new junior loan necessary to implement the second option under Debtor's alternative plan. Debtor does not represent that it has secured a commitment for the new junior loan. Under the proposed new loan, the lender would receive interest at 9 percent per annum. This rate is lower than the 20-percent rate the court found Debtor must pay ITW on the third tranche, while the new lender would be subject to a greater risk of loss than ITW. This is so because the new junior lender, unlike ITW, would be subject to a senior deed of trust held by a different entity. The new junior lender would thus suffer the risk that its collateral could be lost in a foreclosure sale conducted by the senior lender. Thus, there is no reason to believe it likely that Debtor will be able to secure this very unusual new junior financing within a reasonable period of time. Debtor has been afforded a reasonable period of time to confirm a plan. Debtor filed this chapter 11 case ten months ago. The ITW loan matured eight months before the petition date. Because the Debtor has no equity in the Property and has been unable to confirm a plan or refinance the property after an extended period of time, it is appropriate to grant ITW relief from stay to permit foreclosure. **STAY PENDING APPEAL** At the hearing on the order to show cause, Debtor submitted a request for stay pending appeal of this order denying confirmation of Debtor's plan. This court construes that motion as also requesting stay pending appeal of the order granting relief from stay. In determining whether to grant a stay pending appeal, this court should consider the following four factors: (1) the likelihood of success on appeal; (2) irreparable injury if a stay is not granted; (3) the absence of substantial harm to interested persons; and (4) the absence of harm to the public interest. In re Wymer, 5 B.R. 802, 806 (9th Cir. B.A.P. 1980). Although a stay pending appeal should generally be granted only if the appellant demonstrates a significant likelihood of prevailing on appeal, the court may grant a stay if the appellant demonstrates that the appeal raises a serious issue and that the balance of hardships tips sharply in favor of appellant. In re Zaleha, 162 B.R. 309, 317-18 (Bankr. D. Idaho 1993). **A. Merits of Appeal 1. Denial of confirmation.** I determine that Debtor has little likelihood of prevailing on appeal regarding the denial of confirmation of Debtor's First Amended Plan of Reorganization. Setting aside the denial of confirmation will require the reversal of findings of fact. Debtor's plan was not confirmed because Debtor cannot pay ITW an appropriate rate of interest. The determination of the interest rate that Debtor must pay is a question of fact that will be set aside on appeal only if clearly erroneous. Connecticut Gen. Life Ins. Co. v. Hotel Associates of Tucson (In re Hotel Associates of Tucson), 165 B.R. 470, 473 (9th Cir. B.A.P. 1994) (cramdown interest rate). It is worthy of note that ITW's expert testified that the appropriate interest rate was more than 11 percent, and that

Debtor's counsel did not cross-examine him regarding that testimony. Debtor's main argument is that the court should have considered various equitable factors, in addition to evidence regarding market rate, in determining the interest rate ITW must be paid. Debtor argues that in determining the interest rate to be paid on the ITW claim, the court should have considered the following factors even though they would not be considered by a lender in a market transaction: (a) the partner's original investment; (b) the tax consequences of foreclosure to the partners; (c) the original interest rate on the ITW loan (fixed when it was a conforming loan); and (d) the fact that net rental income would decline after foreclosure because property taxes would rise but could not be passed through to the tenants (and thus that ITW would really not benefit by foreclosing). Nothing in the Bankruptcy Code or caselaw supports this approach. Because ITW did not accept the plan, the plan may be confirmed over its objection only if the plan is "fair and equitable." 11 U.S.C. § 1129(b). To be fair and equitable, the plan must provide ITW payments "of a value, as of the effective date of the plan" equal to the amount of its claim. *Id.* That is, if ITW's claim is not paid off on the effective date, it must be paid with interest. The Ninth Circuit has stated that the bankruptcy court should determine the appropriate rate of interest by determining what a market rate of interest would be for a similar loan, and that the bankruptcy judge is to be afforded considerable deference in making such determinations. *Hotel Associates of Tucson*, 165 B.R. at 476. Nothing in the caselaw authorizes the court to abandon use of a market rate of interest on the basis of the type of equitable considerations urged by Debtor. Debtor's argument actually stands the caselaw interpreting the "fair and equitable" language in section 1129(b) on its head. The courts have held that payment of the claim in full with interest is the minimum requirement for a plan to be considered fair and equitable. *In re D&F Constr., Inc.*, 865 F.2d 673, 675 (5th Cir. 1989); *In re Dollar Associates*, 172 B.R. 945, 948 (Bankr. N.D. Cal. 1994).

2. Relief from stay. I determine that Debtor has little likelihood of prevailing on appeal regarding the order granting relief from stay. A bankruptcy judge's decision to grant relief from stay is reviewed for abuse of discretion. *Moldo v. Matsco, Inc.* (*In re Cybernetic Services, Inc.*), 239 B.R. 917, 918 (9th Cir. B.A.P. 1999), *aff'd*, 252 F.3d 1039 (9th Cir. 2001), *cert. denied*, 122 S.Ct. 1069 (2002). Underlying findings of fact are reviewed for clear error. *U.S. v. Wyle* (*In re Pacific Far East Lines, Inc.*), 889 F.2d 242, 245 (9th Cir. 1989). Underlying conclusions of law are reviewed *de novo*. *Id.* The determination that Debtor has no equity is purely one of fact. As noted previously, the court heard expert testimony regarding the value of the property. There was no significant dispute between the parties regarding the balance on the ITW loan. The determination that Debtor is not likely to obtain the financing necessary to confirm its alternate plan of reorganization is not only a question of fact, it is an issue on which the Debtor bears the burden of proof in the relief from stay proceeding. 11 U.S.C. § 362(g).

B. Balance of Hardships I determine that the balance of hardships does not tip sharply in favor of Debtor. The direct hardship on the Debtor from denying a stay pending appeal is that ITW will be able to foreclose, and Debtor will thus lose its only significant asset. The effect of this hardship is attenuated by the fact that Debtor currently has no equity in the Property, and thus stands to lose only the opportunity to reap future appreciation in the Property. The indirect hardship on Debtor is that a foreclosure will constitute a sale or exchange of the Property for tax purposes. Upon such a sale, Debtor will be deemed to realize a sale price equal to the balance on the ITW loan, even though Debtor receives no cash. Because Debtor's tax basis is lower than the balance on the ITW loan, Debtor will recognize a large capital gain. Debtor has introduced evidence that the partners will incur a tax liability of approximately \$13.8 million. ITW does not dispute this calculation. For the purpose of weighing hardship on the Debtor, however, this hardship must be

discounted to some extent, because it is Debtor's partners rather than Debtor that will bear the tax burden. Granting a stay pending appeal would cause harm to ITW, because ITW would be forced to bear the economic risks of ownership without enjoying all of the economic benefits of ownership. The fair market value of the Property is \$97 million and the balance on the ITW loan is \$99.5 million. Thus, it is ITW rather than Debtor that will bear the risk of any decline in the value of the property from the present time until ITW is paid off or is permitted to foreclose. ITW will not, however, reap all the benefit of any appreciation in value during that period. If, for instance, the Property appreciates by \$5 million, ITW would reap one-half of that appreciation by having its loan paid in full, and Debtor would retain the remainder of the appreciation. There are three ways in which this pernicious asymmetry in the allocation of economic risk and benefit can be eliminated. First, economic ownership could be transferred to ITW by allowing ITW to foreclose. Second, the ITW loan could be paid down to a conventional loan-to-value ratio. If the loan represented only 75-80 percent of the value of the Property, Debtor would bear the major risk of decline at the same time that it enjoyed the benefits of appreciation. As noted earlier, the evidence indicates that Debtor is not able to pay down the ITW loan in this manner. Third, ITW could be given an enforceable right to recover a rate of interest sufficient to compensate ITW for the high degree of risk that it is being forced to bear. At the confirmation hearing, I determined that this rate was "at least 10 percent" per annum. Debtor has offered to pay ITW 10 percent during the pendency of the appeal. For the reasons set forth below, however, I determine that this offer does not provide ITW sufficient protection. The problem with Debtor's proposal to make up any shortfall in monthly payments is that it does not provide ITW an enforceable right to receive 10 percent interest over a sufficient period of time. The Property does not create income sufficient to pay 10 percent interest. Debtor's partners propose to make up the shortfall from their personal funds each month. This proposal is an option, not an enforceable promise by Debtor or its partners. If at any time the partners come to believe that the Property is declining in value, they can simply stop funding the shortfall and walk away. ITW would then receive property that has declined in value and have no recourse to any fund to make up that loss. This is a very real risk. The evidence at the valuation hearing showed that the real estate market in the area in which the Property is located is very distressed. The market may be still declining, it may be stabilizing. There is no evidence that rental rates or sale prices have started to recover. Another weakness in Debtor's proposal is that it will give Debtor a strong incentive to cut corners regarding maintenance. Every dollar saved on maintenance will lower the amount of the shortfall that the partners have to make good. **CONCLUSION** Relief from stay should be granted, because Debtor has no equity in the Property, because Debtor was unable to confirm its initial plan of reorganization, and because it is unlikely Debtor will be able to obtain the financing necessary to confirm its alternate plan. Stay pending appeal of the order granting relief from stay and of the order denying confirmation is denied, because Debtor has little likelihood of prevailing on appeal, and because the balance of hardships does not tip sharply in favor of Debtor. /// /// The court will stay the order granting relief from stay for 20 days to allow Debtor to seek a stay pending appeal from an appellate court in an orderly manner.

Dated: MAY 30, 2002 _____

Thomas E. Carlson

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